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Introduction and Summary

¶1. (SBU) The European Union and its 27 member states have been hard hit by the global financial crisis and economic downturn, with the economy in recession and some of the world's largest financial institutions under stress. The EU has responded actively to this, with strident calls for action from EU President Barroso, Commissioners McCreevy and Almunia and the EU Presidency in Czech Prime Minister Topolanek adding to the cacophony of statements from such member state leaders as Brown, Sarkozy, Merkel and the heads of the worst affected Central European member states - notably Hungary and Romania.

¶2. (SBU) Despite the profusion of high level meetings and sometimes contradictory statements (epitomized by the Sarkozy-Topolanek exchange on aid to the auto sector), the Europeans are taking a number of steps to respond to the crisis:

-- common EU principles on fiscal stimulus were announced in December; the Commission claims that the total stimulus now exceeds 3 pct of GDP, double the originally expected 200bn or 1.5 pct of GDP;
-- EU debt and deficit limits will be applied leniently, while member states plan to return to fiscal stability in the medium term;
-- EU and member state funds are supporting some member states

facing balance of payments difficulties, especially in Central Europe;
-- the Commission and member states are (now) generally united against measures that would undermine the internal market, or erect protectionist barriers; -- the Commission is minimizing trade distorting effects of financial institution bailouts and state aids;
-- proposals to strengthen financial sector supervision and regulation are being considered, including on: the De Larosiere recommendations on improving micro- and macro-level supervision; strengthening bank and insurance fund capital requirements; regulating credit rating agencies and credit default swaps; and increased deposit guarantees and investor protections (additional proposals on hedge funds and private equity are expected next month); and
-- on the international front, the EU as a whole supports the G-20 process and has called for doubling IMF resources and strengthening the IMF and Financial Stability Forum's role in financial governance.

¶3. (SBU) Many of these financial reform initiatives, which EU heads of State and Government will review and may expand at their March 19-20 European Council meeting, cause difficulty for the industry and for us, in particular as they inject EU "localization" requirements into a global financial industry. Indeed, many EU leaders (notably McCreevy, Sarkozy and Merkel) openly blame lax regulation in the United States (and United Kingdom) for the crisis, and will come to the London Summit in an assertive and at times combative mood. They understand, however, that the Summit needs to succeed to rebuild confidence among investors and consumers, and are

likely to yield more easily on the details of the substance in exchange for the political messaging they want. End Introduction and Summary.

The Effects of the Crisis on the European Economy

¶4. (SBU) The global financial and economic crisis has hit the EU and its 27 member states hard. The latest European Commission forecasts (Ref E), released January 19, expect GDP to fall sharply (-1.8% in the EU and -1.9% in the 16-member euro area) in 2009, before growing 0.5% in 2010. Dramatically underscoring the scope of the problem, industrial orders in the EU27 as a whole fell by 6.4% in December 2008, after declining by 5.1% in November; orders were 23.3 percent below their level in December 2007. As a result, unemployment in the euro area has reached 8.2% in January, the highest level for two years, and is expected to rise to 8.7% in the EU in 2009 (9.2% in the euro area), with a further increase in 2010. Deficits will also grow in 2009 from 2% of GDP to 4.5% in the EU and from 1.7% to 4% in the euro area. Inflation is set to fall rapidly, from 3.7% in 2008 in the EU (3.3% in the euro area) to 1.2% in 2009 (1.0% in the euro area) and just below 2% in 2010 in both regions. Even with this bad news, EU Economic and Finance Commissioner Almunia last week warned that the forecast may be revised downward.

¶5. (SBU) The ten Central European EU member states are currently suffering their worst economic recession since the Second World War, with Hungary, Latvia and now Romania requesting international assistance. Western investors have been selling assets from the region, pushing the Polish zloty down by 28% against the euro in the past six months. Hungary's forint has fallen by 20%, Romania's leu by 17% and the Czech koruna by 12% during the same period. A Hungarian document calculates that Central Europe's refinancing needs for 2009 could total 300bn, or 30% of the region's gross domestic product (GDP). This regional problem has significant EU-wide effects, as several Western European financial institutions are heavily exposed to the region. According to UBS estimates, Austria's financial system is exposed to Central and Eastern Europe as a whole for 67% of Austria's GDP, followed by Belgium (27%) and Sweden (22%).

The EU Domestic Economic Policy Response

¶6. (SBU) As the first major response to the dramatic downturn, EU Heads of State and Government meeting in the European Council in December adopted the European Economic Recovery Plan (EERP) as a coordinated fiscal stimulus plan worth approximately 200bn or 1.5% of EU GDP. The burden is shared between national budgets (approximately 170bn or 1.2% of GDP), and EU and European Investment Bank budgets (around 30bn, 0.3% of GDP).

¶7. (SBU) Member States are free to decide the mix of measures they intend to adopt to stimulate demand in their economies. In doing so, however, they remain bound by the Stability and Growth Pact rules on excessive deficits (which set nominal ceilings for budget deficits and government debt of 3 and 60 pct. pct. of GDP respectively). As such, their fiscal policy room for maneuver is limited to some extent by their current budgetary position. The Commission intends to apply the Stability and Growth Pact rules flexibly in light of the crisis, but member states are expected to spell out how they intend to reverse excess deficits over the medium term.

¶8. (SBU) Member States in early January reported the details of the national measures they will take in their Stability and Convergence programs for 2009. In a study submitted to the February meeting of the Economic and Monetary Affairs Council, the Commission reported that planned stimulus measures actually exceed the EERP, with the

total at about 3.3 percent for both the 16 Eurozone members and for the EU 27 as a whole. This includes, at the EU level, 2.8 percentage points of GDP added to the fiscal deficit (1.1 percentage points in consolidated annual budget measures and 1.7 percentage points from "automatic stabilizers" such as increased unemployment benefits); 0.3 percentage points for additional debt (generally raised fro equity injections into private sector institutions, mainly banks); and 0.2 percentage points in measures outside the budget, including by state-owned enterprises. However, analysts have argued that many of the measures member states have put forward were already planned and thus should not be viewed as new stimulus.

¶9. (SBU) At the EU level, the Community is unable to provide aggregate fiscal stimulus since it must by law run a balanced budget on an annual basis. Further, EU revenues are limited as a portion of GDP, so that declines in economic activity will lead directly to a decrease in expenditures. That said, the Community can alter expenditure patterns, and the Commission has proposed that the Community contribute to the EERP by accelerating payments of up to 6.3bn under the structural and social funds and by mobilizing 5bn of unspent money from the 2008 budget over the period 2009-10 to improve energy interconnections and broadband infrastructure. This last initiative, the brain-child of Commission President Barroso (Ref D), may not gain sufficient member state support to be approved by the March 19-20 European Council, as member states see it as largely political (in fact, that is its main selling point), too slow on disbursements, too incoherent in choice of projects, and too difficult to finance from the EU budget. Also at the EU level, the European Investment Bank will also increase annual lending, particularly to SMEs, by some 15bn in 2009 and 2010.

¶10. (SBU) In an attempt to build support for an EU wide response to the particular crisis in Central Europe, in January, Austrian banks pressed the European Union to organize financial aid for countries on its eastern fringes like Romania and Ukraine. That call was followed by the Austrian government's attempt to seek support for an EU initiative to mobilize additional resources for the region's banking system, which would include funds from the European Investment Bank, the European Central Bank and the EU Cohesion Fund. The EU rejected that plan. A second proposal put forward by Hungary at the March 1 extraordinary leaders' summit called for the establishment of a fund worth 160-190bn to provide liquidity and debt rescheduling for Central European states. Poland, Slovakia and the Czech Republic all resisted such a regional approach, as they want to distinguish themselves from their more imperiled neighbors. Leaders opted to help the region's troubled economies on a country-by-country basis.

-- Industrial Supports

¶11. (SBU) The EU rightly prides itself on having established a single market among its 27 members, and the Commission zealously guards this from state aid and other measures that might distort internal competition. That said, the EU has not yet adopted state aid frameworks targeted at particular sectors of the economy other than the financial sector (below). To soften the effects of the credit squeeze, and to help the real economy in general, on December 17 the Commission adopted a temporary framework which allows Member States to grant, under certain conditions and until 2010, a lump sum of aid up to 500,000 per company for the next two years, state guarantees for loans at a reduced premium, subsidized loans, in particular for the production of green products, and risk capital aid up to 2.5 million per SME per year (instead of the current 1.5 million) in cases where at least 30% (instead of the current 50%) of the investment cost comes from private investors.

¶12. (SBU) Over the past few weeks, member states have submitted for Commission approval support schemes targeted at industries with particular national relevance, such as the automotive industry for

Italy, Germany and France. The latter sparked accusations of protectionism from newer Member States, the Czech Republic in particular, as it tried to link aid to the relocation of production within France's borders. The Commission finally authorized this scheme on February 28, after the contentious conditions were removed. On March 1, the 27 EU Leaders meeting in an informal European Council reaffirmed their commitment to the single market and warned against letting protectionism slip through the back door.

-- Labor Market Measures

¶13. (SBU) In 2007, the European Union launched the European Globalization Adjustment Fund, to help workers made redundant as a result of changing global trade patterns to find another job as quickly as possible. The fund provides up to 500 million a year in support, and it will be used to reduce the broader social impact of the crisis and support vulnerable populations across the EU. In parallel, the Commission is working with Member States to re-program the European Social Fund to help keep people in employment.

¶14. (SBU) On February 25, the "Social Partners" (industry federations and labor unions) met with the Commission to start preparing proposals for an extraordinary summit on employment to be held in Prague in May. The March 19-20 European Council will discuss these issues in more detail.

The EU Domestic Monetary and Financial Regulatory Response
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¶15. (SBU) The strains caused by the crisis have led some to question whether the Eurozone may break up. Some Euro area Member States such as Ireland, Greece, Spain, and Portugal have seen the spreads on their debt over German Bund widen significantly over the past weeks. This has triggered a debate on whether or not a default of one or more Euro area Member States is possible, especially since current EU rules do not allow for bailing-out a Euro area member. While a default is possible, it is unlikely and the advantages of EMU are such that it is unlikely to break apart. As Commissioner Almunia said on March 3, "If a crisis emerges in one euro area country, there is a solution. Before visiting the IMF, you can be sure there is a solution and you can be sure that it is not clever to talk in public about this solution".

¶16. (SBU) The EU financial sector has been hard hit by the financial crisis: according to the Commission's latest report of national measures to support the banking sector, member states have taken action to support nearly 20 specific institutions since September of last year, including Northern Rock, Royal Bank of Scotland, ING, and Fortis, and almost all member states have sought Commission approval for general schemes to support the sector.

¶17. (SBU) The European response to the financial crisis began in October 2008, focusing first on recapitalizing banks, issuing loan

guarantees to sustain lending activities and raising deposit guarantees. The Commission also proposed a number of legislative actions to increase deposit guarantees, to strengthen bank and insurance companies' capital requirements (the Capital Requirements Directive and Solvency II), and to register and regulate credit rating agencies (CRA). It has also announced further legislative proposals to regulate hedge funds and private equity firms, executive compensation, and the disclosure requirements of mutual funds. Further, last Fall the Commission created an independent group to make recommendations on how to strengthen cross-border financial supervision; the De Larosiere Group's report was released in late February; on March 4 the Commission adopted proposals largely tracking its recommendations. Specifics follow.

-- Guidelines on Support for Financial Institutions

¶18. (SBU) From October 2008 to February 2009, the Commission adopted three guidelines to ensure that member state assistance to the banking sector does not distort competition. On October 13, the first document included guidance to help Member States design rescue packages for distressed financial institutions and state guarantee schemes that were to be non discriminatory, limited in time and scope, and with adequate compensation for capital and guarantees by the receiving institutions and protection against abuse. On December 8, the Commission published further guidance on temporary support for "fundamentally sound banks", to help them restart credit flows. Capital injections must be based on base rates set by central banks to which a risk premium is added to reflect the risk profile of each bank and the type of capital. The pricing mechanism must be such as to keep public involvement to a minimum. Finally, on February 25, the Commission further refined its guidance with guidelines on how Member States should deal with impaired assets. The guidelines leave the design of asset relief schemes up to the Member States, which can use several approved methods (asset purchase, including "bad bank" scenarios or asset insurance schemes), and indicate the budgetary and regulatory implications of such measures. The Commission will grant approval for these measures for a period of six months, conditional on the commitment to present details of the valuation of the impaired assets.

-- Financial Regulation (Ref C)

¶19. (SBU) Deposit Guarantees: Legislation to raise deposit guarantees to 50,000 in 2009 and to 100,000 by 2011 was formally adopted by the Council on February 27, following a vote by the EP on December 18.

¶20. (SBU) Capital Requirement Directives (CRD): Last October, the Commission put forward a proposal amending the CRD by (1) requiring banking institutions to hold a higher amount of capital to protect against the risk of default; (2) creating ad-hoc Colleges of Supervisors that will supervise banks with cross-border operations; and (3) requiring financial institutions that originate securitized products to retain 5% of the securities (refs F and G). The 5% securitization retention threshold seems to be generally accepted, and there is agreement that Colleges of Supervisors, though not a satisfactory end-solution, are an appropriate interim step towards more integrated European supervision. A vote is expected by April.

20A. (SBU) Derivatives Trading: EU Internal Markets Commissioner McCreevy has made no secret about his desire to regulate derivatives trading. The Commission published a Communication on this last fall, which indicated it believed that all derivatives should be traded through an EU-based, registered and supervised Central Clearing Party (CCP). When major traders were unwilling to accede to doing this "voluntarily," McCreevy threatened to compel it through legislation, and then encouraged the Chairman of the European Parliament's Economic and Monetary Affairs Committee to add his proposal directly as an amendment to the CRD even though it had not gone through the formal Commission process. On February 18, nine influential member firms of the International Swaps and Derivatives Association (ISDA) agreed to commit to use EU-based central clearing for Credit Default Swaps (CDS) on EU-reference entities by end-July 2009. Given the industry's concession, it is

not clear whether this provision will be included in the final version of the CRD.

¶21. (SBU) Solvency II: Solvency II aims at consolidating insurance sector legislation. Although work started before the crisis hit Europe, its provisions for group-wide supervision and support -- giving the supervisor of the State where the insurance group is established a leading role in supervisory activity and coordination, and allowing capital requirements to be met at a group level rather than by individual subsidiaries on their own -- are seen as

important in the current climate. It is not certain this legislation will be completed before the EP recesses in April, given strong Member State concerns about group support and group supervision, both desired by the Commission and the European Parliament. A compromise may be possible on both issues, however, and a vote by the EP plenary is expected by the end of March.

¶22. (SBU) Credit Rating Agencies (CRAs): Last November, the Commission proposed a new Regulation to harmonize EU rules on CRAs to ensure that ratings are not affected by conflicts of interest, that CRAs defend the quality of their ratings and rating methodology, and that they act transparently. The proposal calls for all CRAs whose ratings are used in Europe to be registered in the EU and subject to European supervision under stringent corporate governance rules; it also forbids financial institutions in Europe from trading instruments that do not carry a rating from an-EU registered CRA. The Parliament is modifying the Commission's proposal to give primary responsibility for CRA registration and supervision to the Committee of European Securities Regulators (CESR), rather than to national regulators, and to allow EU-registered CRAs - including EU subsidiaries of non-EU headquartered CRAs - to endorse ratings prepared by non-EU-registered CRAs for a transitional period of two to three years, during which EU and third country regulators can work out criteria to determine regulatory equivalence. A Committee vote is expected by March 23, and completion of the first EP reading by the end of April. In the Council, member states favor registration and supervision of CRAs, and appear to agree on the "endorsement" approach for instruments rated by non-EU-based CRAs, but have misgivings about the EP's enhanced role for CESR and the need for equivalence determinations for third country CRAs.

¶23. (SBU) Hedge Funds and private equity: Commissioner McCreevy announced recently that a legislative proposal will be put forward this spring, although at a recent Conference organized by the Commission, no significant policy indications emerged.

¶24. (SBU) Review of the Prospectus and Transparency Directives: In an effort to improve and simplify the Prospectus and Transparency directives, which concern disclosure to investors for investor protection purposes, the Commission has recently launched a consultation to gather stakeholder views on issues such as disclosure requirements and exemptions. A legislative proposal could follow before the summer break.

¶25. (SBU) Review of the Investor Compensation Schemes Directive: Following recent legal disputes over liability for losses sustained in the Madoff case, the Commission recently launched a call for evidence on the application of the Investor Compensation Schemes Directive in Member States with a view to propose greater harmonization. This Directive's aim is to protect investors against losses if a firm is unable to repay money, or return assets, held on behalf of their clients.

-- Financial Supervision (Ref B)

¶26. (SBU) The main building block for the EU position on financial markets regulation going into the London G-20 is the publication on February 25 of the report of the High Level Group on cross-border financial supervision, chaired by former IMF chief Jacques De Larosiere. The De Larosiere report lays out a proposal for a framework which includes a new regulatory agenda (reducing risk; improving systemic shock absorbers; reducing pro-cyclicality), stronger coordinated supervision (both macro-prudential and

micro-prudential), and effective crisis management. The key recommendations include a revision of Basel II to reduce pro-cyclicality, a reform of mark-to-market and of the IASB governance, and an overhaul of the European macro and micro financial supervision. The Commission on March 4 adopted

legislative proposals that closely track the De Larosiere recommendations; these will be discussed by Economic and Finance Ministers on March 10 and deliberated further by Heads of State and Government at the March 19-20 European Council.

Approach to the G-20

¶27. (SBU) The EU and its member states generally support the G-20 process, although the Europeans often have difficulty dealing with events at which the EU as a whole but only some of the member states are participants. The March European Council meeting will attempt to agree on an overall EU approach to the April 2 G-20 Summit, which will limit to a certain extent the freedom of initiative of any one EU member state - including the UK as host. This explains to a large extent the internal EU maneuvering surrounding the preparations for the Summit, including the February 22 meeting in Berlin that Chancellor Merkel called of the EU Heads of State and Government who will attend the G-20 Summit. (Note: The Commission, traditionally not represented in the G-20 Finance Ministers process, participates in the G-20 leaders process and will use this to work toward a common EU position. It represents the EU in some of the G-20 working groups.)

¶26. (SBU) Indeed, at the February 22 meeting, the EU G-20 leaders pledged the EU will speak with one voice in London, stressing in particular the need to:

-- strengthen supervision and regulation of financial markets, hedge funds and rating agencies;
-- revise Basel II to reduce pro-cyclicality;
-- reform mark-to-market requirements in international accounting standards, and improve the governance of the IASB;
-- clamp down on tax havens with increased capital requirements for off shore centers;
-- obligate banks to implement counter-cyclical measures and limiting bonus payments;
-- create a sustainability charter, to reduce economic imbalances and stabilize financial markets;
-- give a mandate to the IMF and the FSF to implement the financial action plan; and
-- double the financial resources for the IMF.

¶27. (SBU) All these issues are being fleshed out in this week's Economic and Finance Council (see septels) and will be endorsed by the European Council at the end of next week.

Broader Impact on US-EU relations

¶28. (SBU) The depth and breadth of transatlantic economic ties has traditionally been seen as the bedrock for the overall US-EU relationship, but the financial crisis has created cracks in that foundation. Many prominent EU leaders have publicly blamed lax financial regulation in the United States for the economic collapse, and indeed for some of the tensions that have developed within the EU as a result. And they were quick to criticize the United States for what they perceived as "protectionist tendencies" in the Buy America provisions of the stimulus package, although that has died down with our assurance that we would implement Buy America consistent with our WTO and other international obligations.

¶29. (SBU) As such, we expect some vinegar from the EU representatives at the London Summit, including Commission President Barroso, who will be accompanied by Economic and Financial Affairs Commission Almunia and, we expect, Internal Market and Financial Regulation Commissioner McCreevy. McCreevy in particular has made no bones about how the EU, as the world's largest economy, "has the right to regulate the financial industries as we see fit," or so he

told last December's Transatlantic Economic Council meeting.

¶30. (SBU) That said, the EU's position will be tempered by three things: the overall popularity of the Obama Administration in Europe, the need for the London Summit to be perceived as a success to help restore investor and consumer confidence, and the tendency of the experts in the Economic and Finance Committee, who are working on the Commission's proposal, to be more pragmatic when dealing with the substantive details.

¶31. (SBU) The overall desire of the Europeans to be seen as the new Administration's primary partner in addressing global challenges will be a major factor in constraining EU criticism at the London Summit; they are all aware they will see the President directly afterward at the NATO 60th Anniversary Summit and at his meeting with the 27 EU Heads of State in Government in Prague. They want to be helpful. But the economic downturn has had substantial effects on all member state budgets, imposing unwished for constraints on member states' ability to increase spending on such things as defense capabilities or the EU and the member states to plus up foreign assistance, where they are together the world's largest donors. Nonetheless, they will want to continue to work with us, and will try to find creative ways to do so.

MURRAY